No. 84-104

In the Supreme Court of the United States

OCTOBER TERM, 1984

RUSSELL REDHOUSE, JR., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether a 1977 amendment to Section 1.612-3(b)(3) of the Treasury Regulations on Income Tax is invalid under the Administrative Procedure Act because the amendment was not published in the Federal Register in final form 30 days before its designated effective date.

2. Whether the Commissioner abused his discretion under Section 7805(b) of the Internal Revenue Code by making the amendment described above retroactive to October 29, 1976, the date on which the proposed amendment was publicly announced.

3. Whether the Tax Court has jurisdiction to rule on objections to the validity of Treasury Regulations where such objections are based on provisions of the Administrative Procedure Act.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-21) is reported at 728 F.2d 1249. The opinion of the Tax Court (Pet. App. 24-67) is reported at 79 T.C. 355.

JURISDICTION

The judgment of the court of appeals was entered on March 20, 1984. The petition for a writ of certiorari was filed on July 18, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner is a limited partner in a partnership known as Tennessee Coal Resources, Ltd. (TCR). The partnership was formed on December 30, 1976 (Pet. App. 1-2). On December 31, 1976, TCR acquired a lease interest in a coal mine by transferring $650,000 in cash and a $2,350,000 nonrecourse note to the lessor of the mine (*id.* at 2-3). TCR

mined no coal during 1976 (*id.* at 3). TCR characterized the entire $3 million payment as a lump-sum advance royalty and claimed a deduction in that amount on its 1976 partnership income tax return. Petitioner reported his pro rata share of that deduction on his individual tax return for 1976 (*ibid.*).

Petitioner acquired his TCR limited partnership interest as a result of an offering memorandum dated November 12, 1976 (Pet. App. 12). That memorandum referred to a news release issued by the Internal Revenue Service on October 29, 1976, announcing a proposed amendment to Treas. Reg. § 1.612-3(b)(3), which governs the tax treatment of advance royalties (Pet. App. 39-40). Under the proposed amendment, published in the Federal Register on November 2, 1976 (41 Fed. Reg. 48133), advance royalties generally were to be deductible by the payor only in the year of sale of the mineral with respect to which the royalty had been paid. The news release also announced the temporary suspension of Rev. Rul. 70-20, 1970-1 C.B. 144, and of Rev. Rul. 74-214, 1974-1 C.B. 148, which had indicated that mineral royalties could generally be deducted in the year in which paid or accrued (Pet. App. 47-48). The news release specifically stated that the proposed amendment to the regulation, if adopted, would apply to all leases entered into on or after the date of the announcement, that is, on or after October 29, 1976 (*ibid.*). The TCR offering memorandum specifically warned potential investors of the risk that the Commissioner, on the basis of the amended regulation, would challenge TCR's deduction of the advance royalty that TCR planned to pay (and did pay) on December 31, 1976 (*id.* at 2, 12, 39-40). The opinion of tax counsel, attached to the offering memorandum, advised that the IRS "will almost certainly * * * challenge the deductibility of the advanced royalty" (*id.* at 43).

A public hearing on the proposed amendment to the regulation, following solicitation and receipt of public comments, was held on November 30, 1976 (Pet. App. 4). The final version of the amendment, which was substantially similar to the proposed version, was published in the Federal Register on December 19, 1977 (42 Fed. Reg. 63640-63641). Accompanying that publication was a statement indicating that the amendment, as previously announced, would be applied to all transactions that became effective on or after October 29, 1976 (*ibid.*) In accordance with the amended regulation, the Commissioner, on audit, disallowed the advance royalty deductions claimed by petitioner and the other TCR limited partners for 1976, since TCR did not produce or sell any coal in that year (Pet. App. 3).

Petitioner sought redetermination of the resulting deficiency in the Tax Court,[1] contending that the retroactive application of the amendment to Treas. Reg. § 1.612-3(b)(3) was impermissible. He argued that the amendment's retroactive application violated the Administrative Procedure Act (APA) and that Congress had legislatively reenacted the earlier version of the regulation (Pet. App. 47-54).[2] The Tax Court rejected those arguments and sustained the asserted deficiency, without reaching the Commissioner's alternative contention that TCR's execution of the $2.35 million nonrecourse note did not constitute sufficient payment to support the claimed deduction in any event (*id.* at 54-55).

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[1]The Tax Court consolidated petitioner's case with cases involving nine other TCR partners. They appealed the Tax Court's adverse decisions to the Eleventh Circuit, which affirmed. *Wendland* v. *Commissioner*, 739 F.2d 580 (1984).

[2]Petitioner did not otherwise contest the correctness of the rule set forth in the amended regulation.

The court of appeals unanimously affirmed, holding that the Secretary of the Treasury did not abuse his discretion in applying the amended regulation retroactively to transactions entered into after October 29, 1976, the date the proposed amendment was publicly announced (Pet. App. 5-13). The 1977 amendment, the court observed, did not change settled law, since the prior version of the regulation had permitted deduction only of *annual* advance royalties, without referring to the deductibility of *lump-sum* advance royalties of the sort involved here (*id.* at 6-7). It was not until 1974, the court noted, that the Commissioner, in Rev. Rul. 74-214, interpreted the regulation to permit deduction of such lump-sum payments. The court concluded that Congress could not be said to have approved, explicitly or implicitly, the interpretation set forth in Rev. Rul. 74-214, because there had been no change in the underlying statute since 1974 (Pet. App. 10-11). And the court held that retroactive application of the amended regulation would not be unduly harsh to petitioner, since he had ample notice of the proposed amendment before he acquired his TCR limited partnership interest (*id.* at 12-13).

The court of appeals likewise rejected petitioner's contention that the amendment's retroactive application was contrary to a provision of the Administrative Procedure Act, 5 U.S.C. 553(d), which generally requires that a "substantive rule" be published in the Federal Register 30 days before its effective date. The court concluded that Section 7805(b) of the Internal Revenue Code, which grants the Secretary broad discretion to apply tax regulations retroactively, controls over Section 553(d), which concerns the rulemaking power of admininistrative agencies generally (Pet. App. 13-15). And the court held in the alternative that Section 553(d) would not apply here in any event, since the amendment in question was not a "substantive rule" but an "interpretative rule" exempt from the APA's effective date provisions under 5 U.S.C. 553(d)(2) (Pet. App. 15-16).

Finally, the court rejected petitioner's argument that the Tax Court lacked subject matter jurisdiction to decide whether the amended regulation had been promulgated in compliance with the APA. The court of appeals reasoned that the Tax Court was properly constituted as an Article I court and that its jurisdiction to determine the correct amount of petitioner's tax necessarily encompassed the power to determine the validity and applicability of the regulation under which the deficiency in tax had been asserted (Pet. App. 16-17, 19-21 n.2).

ARGUMENT

The decision below is correct. Contrary to petitioner's contention, there is no conflict among the circuits on any of the questions presented. Indeed, the decision below is fully in accord with the only other appellate decision on point, *Wendland* v. *Commissioner*, 739 F.2d 580 (11th Cir. 1984), which arose out of the same transaction and presented identical issues, and which expressly followed the reasoning and result of the court of appeals here.

1. Section 7805(b) of the Code[3] provides that the Secretary "may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect." This Court and the courts of appeals have uniformly interpreted Section 7805(b) and its predecessors to mean that tax regulations are presumptively retroactive, and that the Commissioner's election not to remove that retroactive feature is reviewable only for abuse of discretion. *Dixon* v. *United States*, 381 U.S. 68, 72-76 (1965); *Automobile Club* v. *Commissioner*, 353 U.S. 180, 183-184 (1957); *Wilson* v. *United States*, 588 F.2d 1168, 1171-1172 (6th Cir. 1978); *Anderson, Clayton & Co.* v. *United States*, 562 F.2d 972, 980-981 (5th Cir. 1977),

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[3]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

cert. denied, 436 U.S. 944 (1978); *Jones* v. *United States*, 553 F.2d 667, 670 (Ct. Cl. 1977). See *Dickman* v. *Commissioner*, No. 82-1041 (Feb. 22, 1984), slip op. 12-13 ("[I]t is well established that the Commissioner may change an earlier interpretation of the law, even if such a change is made retroactive in effect.").

Petitioner, however, argues (Pet. 9-26) that the IRS's power to promulgate retroactive regulations is limited by the Administrative Procedure Act, which generally requires (5 U.S.C. 553(d)) that a "substantive rule" be published in the Federal Register not less than 30 days before its effective date. Specifically, petitioner contends that the 1977 amendment to Treas. Reg. § 1.612-3(b)(3) cannot be applied in this case because it was not approved and published in final form until December 1977, eleven months after TCR made its lump-sum advance royalty payment.

The court of appeals properly rejected petitioner's argument on two independent grounds. First, Section 7805(b) is a specific statute giving the Secretary broad discretion to apply tax regulations retroactively. Section 553(d) of the APA, by contrast, is a generalized statute governing rulemaking by all federal administrative agencies. It is elementary that a specific statute controls over a general one. *Morton* v. *Mancari*, 417 U.S. 535, 550-551 (1974); *Bulova Watch Co.* v. *United States*, 365 U.S. 753, 758 (1961). The court of appeals thus correctly held (Pet. App. 15) that Section 7805(b) takes precedence over the general provisions of 5 U.S.C. 553(d).[4]

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[4]Petitioner's contention (Pet. 14-15, 49) that the decision below conflicts in this respect with *Rowell* v. *Andrus*, 631 F.2d 699, 701 (10th Cir. 1980), and with *United States* v. *Gavrilovic*, 551 F.2d 1099, 1104 n.9 (8th Cir. 1977), is frivolous. Those cases, involving regulations respectively promulgated by the Interior Department and the Drug Enforcement Agency, did not involve the application of Section 7805(b) of the Internal Revenue Code or of any analogous statutory provision. Indeed,

Second, even if we were to assume that the APA's 30-day notice requirement inhibits the Commissioner's authority to promulgate retroactive tax regulations, the court of appeals properly concluded (Pet. App. 15-16) that the amendment at issue here is an "interpretative rule" and as such would be excepted from that requirement under 5 U.S.C. 553(d)(2). As the court below noted (Pet. App. 16), in contrast to the situation here, Section 611(a) of the Code directs the Secretary to prescribe regulations concerning the determination of a "reasonable allowance for [mineral] depletion." Regulations pertaining to mineral depletion and promulgated pursuant to that statutory authorization would thus arguably be "legislative regulations"[5] and hence "substantive rules" within the meaning of APA Section

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the court below was the first court of appeals to consider whether Section 553(d) of the APA limits the Secretary's discretion under Section 7805(b) to issue tax regulations having retroactive effect. The only court of appeals that has considered that question subsequently —the Eleventh Circuit in *Wendland, supra* — specifically adopted both the reasoning and the result of the court of appeals here.

[5]In the federal tax context, regulations issued pursuant to a specific statutory delegation of authority, whereby the Commissioner is directed to prescribe a detailed set of rules to implement a particular section of the Code, are considered "legislative" in character. See, *e.g.*, I.R.C. § 1502 ("The Secretary shall prescribe such regulations as he may deem necessary" to implement the right of affiliated corporations to file a consolidated tax return). Legislative regulations generally have the force and effect of law so long as they are within the scope of the statutory delegation. "Interpretative regulations," issued under the Commissioner's general authority to interpret and clarify the Code, are also entitled to great weight in construing the statute, although to somewhat less weight than legislative regulations. See, *e.g.*, *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981). The provisions of Section 7805(b), granting the Commissioner discretionary authority to prescribe the retroactive effect of tax regulations, have been held applicable to legislative as well as to interpretative regulations, and the courts have looked to the same factors in determining whether the Commissioner abused his discretion in making either sort of regulation retroactive. *E.g.*, *Anderson, Clayton & Co.*, 562 F.2d at 984.

553(d). The regulation at issue here, however, was promulgated under Section 612 of the Code and concerns, not mineral depletion, but the allowance of a deduction for royalty payments as an ordinary and necessary business expense (I.R.C. § 162) or as an expense for the production of income (I.R.C. § 212). This regulation was not issued pursuant to any specific delegation of legislative authority, but pursuant to the Commissioner's general authority under Code Section 7805(a) to prescribe "all needful rules and regulations for the enforcement of" the Internal Revenue Code.[6] The 1977 amendment to the regulation, moreover, served only to clarify its predecessor's ambiguous provisions respecting the deduction of advance royalties. See page 9, *infra*. Thus, as the court of appeals concluded (Pet. App. 16), the amendment at issue is an "interpretative rule" to which the APA's 30-day notice provision would not apply.[7]

2. Petitioner's assertion that the decision below grants the Commissioner "unlimited authority to apply treasury regulations retroactively" (Pet. 26, 27-39) is specious. The court of appeals clearly recognized (Pet. App. 5-6) that the Commissioner's decision to apply a regulation retroactively "is review[able] for an abuse of discretion." The court concluded that the Commissioner did not abuse his discretion

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[6]The Treasury Decisions proposing and adopting the challenged amendment to Treas. Reg. § 1.612-3(b)(3) list Section 7805(a) as the sole authority for its promulgation. See 41 Fed. Reg. 48133 (1976); 42 Fed. Reg. 63640-63641 (1977).

[7]Petitioner errs in contending (Pet. 17-18) that the decision below, insofar as it treats the amendment to Treas. Reg. § 1.612-3(b)(3) as an "interpretative rule," conflicts with *Green* v. *United States*, 460 F.2d 412 (5th Cir. 1972). That case involved an entirely different regulation (Treas. Reg. § 1.611-2(d), governing determination of the fair market value of certain mineral property), and the Fifth Circuit did not state whether that regulation should be considered legislative or interpretative in character. See 460 F.2d at 417 n.4.

here because (1) the 1977 amendment did not change settled law, (2) the particular interpretation of the unamended regulation upon which petitioner relied had never been approved by Congress, and (3) retroactive application to petitioner of the amended regulation would not produce a harsh result (Pet. App. 6-13). These factors are the same as those used by other courts of appeals in determining whether a tax regulation's retroactive application constitutes an abuse of discretion. See, *e.g., Anderson, Clayton & Co.*, 562 F.2d at 981; *Wilson*, 588 F.2d at 1171-1172; *Chock Full O'Nuts Corp.* v. *United States*, 453 F.2d 300, 302-303 n.6 (2d Cir. 1971).

This Court has occasionally declined to give retroactive effect to a regulation that changes settled law (see *Helvering* v. *R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939)), but the 1977 amendment to Treas. Reg. § 1.612-3(b)(3) plainly did not do that. As the court below observed (Pet. App. 7), the unamended version of the regulation permitted the deduction of *annual* advance royalty payments, but did not specifically address the question whether a single, lump-sum payment of the sort involved here would be deductible in the year paid. Thus, the language of the former regulation itself did not provide any secure foundation for the deduction petitioner claimed, and it was not until 1974 that the Commissioner, in Rev. Rul. 74-214, *supra*, interpreted the regulation to allow immediate deduction of lump-sum advance royalties.[8] Just two years later, that ruling was suspended and the proposed amendment was published. Under such circumstances, the interpretation of the regulation advanced in Rev. Rul. 74-214 hardly constituted such

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[8]The other revenue ruling suspended by the IRS's October 29, 1976, announcement, Rev. Rul. 70-20, *supra*, dealt with the deductibility of minimum royalty payments required over the first nine years of a lease, and thus could not have served as a basis for deducting a single, lump-sum royalty like that involved here.

"settled law" as to preclude suspension of the ruling and application of the amended regulation to transactions entered into after the proposed amendment was publicly announced. See *Dixon*, 381 U.S. at 72-76 (holding that the Commissioner is entitled to withdraw erroneous rulings retroactively even where taxpayers have relied detrimentally on them).

By the same token, petitioner errs in contending (Pet. 32-35) that Congress implicitly approved the interpretation of the regulation set forth in Rev. Rul. 74-214. As the court of appeals noted (Pet. App. 11), that ruling was the first and only administrative pronouncement that authorized the immediate deduction of a lump-sum advance royalty, and "it cannot be said that Congress approved [that] ruling because there was no change in the pertinent underlying statutory law since 1974."

Finally, petitioner's assertion that a regulation may not be applied retroactively "where its application would be against the interest of the taxpayer" (Pet. 36) is simply wrong. Retroactive application of regulations is often against the interest of the taxpayer, but, as the court of appeals observed (Pet. App. 12), the Commissioner is precluded from giving regulations retroactive effect only in those rare situations where "the result would be unduly harsh to a particular taxpayer." See *Anderson, Clayton & Co.*, 562 F.2d at 981. Application of the amended regulation to petitioner cannot possibly be judged "unduly harsh," since the November 12, 1976, offering memorandum on which he relied in making his limited partnership investment specifically warned him that the IRS had proposed to amend the regulation, that the amendment would apply to all leases entered into on or after October 29, 1976, and that the IRS on the basis of that amendment would "almost

certainly * * * challenge the deductibility of the advanced royalty" that TCR planned to pay (Pet. App. 43).[9]

3. Petitioner's final contention — that the Tax Court lacks jurisdiction to consider "constitutional issues related to the determination of a Federal tax deficiency" (Pet. 39) — is also meritless. The Tax Court, to begin with, did not consider any constitutional questions in this case (see Pet. App. 46-54). Petitioner's real complaint seems to be that the Tax Court, as an Article I court, lacks jurisdiction "to review compliance of a regulation in accordance with the APA" (Pet. 40). The question whether a regulation complies with the Administrative Procedure Act, however, is not a constitutional question. In any event, the court of appeals was plainly correct in holding (Pet. App. 17-18, 19-21 n.2) that the Tax Court had jurisdiction to consider the validity of Treas. Reg. § 1.612-3(b)(3).

As the court below noted (Pet. App. 17), the Tax Court is a legislative court properly established under Article I of the Constitution (I.R.C. § 7441) and expressly empowered by Congress to determine the correct amount of an asserted deficiency in tax (I.R.C. §§ 6214(a), 7442). The Tax Court thus necessarily has the power to consider the validity of a regulation on which the Commissioner relies in asserting a deficiency, and its jurisdiction to consider the validity of

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[9]Petitioner likewise errs in asserting (Pet. 36-38) that retroactive application "would result in disparative [sic] treatment between similarly situated taxpayers." To the contrary, all transactions entered into on or after October 29, 1976, are treated in precisely the same way. The Commissioner's choice of October 29, 1976, as the effective date was reasonable, because that is the day on which the proposed amendment was publicly announced. See *United States* v. *Darusmont*, 449 U.S. 292 (1981). Taxpayers who entered into such transactions after October 29, 1976, obviously, are not "similarly situated" with respect to taxpayers who became obligated to pay advance royalties under agreements signed before the proposed amendment was made public.

such a regulation cannot logically be affected by the statutory origin (be it the Administrative Procedure Act or the Internal Revenue Code) of the taxpayer's challenge. Indeed, if the Tax Court could not have considered petitioner's challenge to the validity of the amended regulation, it would follow that the court would have been bound to sustain the Commissioner's asserted deficiency without regard to the merits of petitioner's contentions.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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